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∞ **ALM 101** ∞

**AN INTRODUCTION TO
INTEREST RATE RISK (IRR)**



∞ **ALM 101** ∞

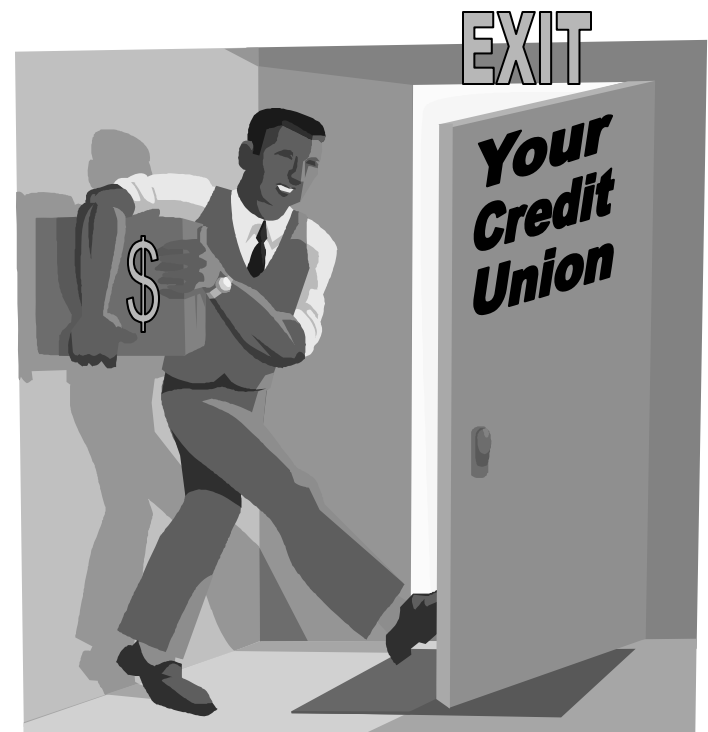
AN INTRODUCTION TO INTEREST RATE RISK (IRR)

**PRESENTED BY
MARK H. SMITH**



❧ **SESSION 5** ❧

**NONMATURITY
SHARES AND
DEPOSITS**



∞ OBJECTIVES ∞

What You Will Learn —

*Learn to identify
nonmaturity shares
and deposits and
assess their true
economic nature*



NONMATURITY SHARES AND DEPOSITS

- ❖ **Have no maturity date and may be withdrawn tomorrow or never**
- ❖ **Technically are short-term**
- ❖ **Typically constitute a large portion of the credit union's total shares (deposits)**
- ❖ **However, their economic substance may be significantly different from their economic form**
- ❖ **Substance vs. form—In the financial world, financial instruments often take on different financial characteristics than their legal form**
- ❖ **Because of optionality**



SUBSTANCE vs. FORM

It is very important—

*that we recognize and treat the
financial components in the
balance sheet, based on
their economic substance*

SUBSTANCE vs. FORM EXAMPLE



30-YEAR FIXED-RATE, REAL ESTATE LOANS

Legal Form—Matures (based on schedule) in 30 Years

❖ ECONOMIC SUBSTANCE IS VERY DIFFERENT

- In falling rate environment — may be very short-term
- In normal times — matures in 5 to 10 years
- In rates-up shock — matures in 10 to 20 years
- Legal form (30-year payout per schedule) — almost never happens



SUBSTANCE vs. FORM EXAMPLE

REGULAR SHARES

Legal Form—Short-Term and Rate-Sensitive

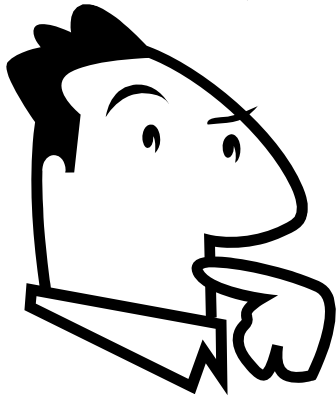
❖ **ECONOMIC SUBSTANCE—Very Different**

	2003	2006	2008
Short-term savings	1.0%	5.5%	3.0%
Share rate	.5%	1.0%	1.0%
Total shares	Slight decline		

SUBSTANCE vs. FORM EXAMPLE

REGULAR SHARES

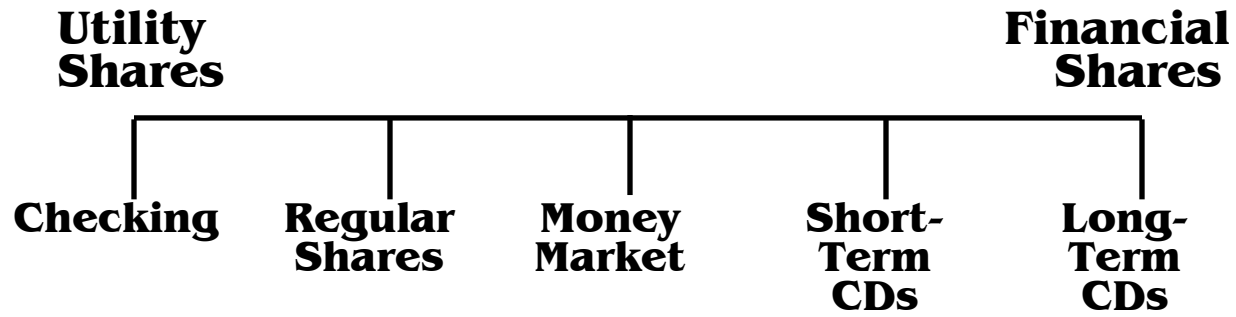
❖ CONCLUSION



- Regular shares are **NOT** rate-sensitive
- Regular shares are **NOT** short-term

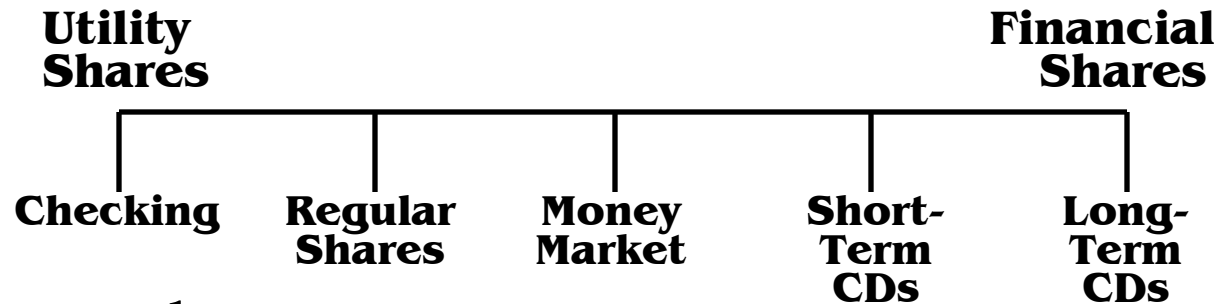
SUBSTANCE vs. FORM

FACTORS THAT AFFECT THE ECONOMIC SUBSTANCE OF SHARES



SUBSTANCE vs. FORM

FACTORS THAT AFFECT THE ECONOMIC SUBSTANCE OF SHARES



- ❖ What you name them
 - High Yield Shares
 - Security Shares
- ❖ Membership demographics
- ❖ Competition
 - Local
 - Internet

SUBSTANCE vs. FORM

❖ Management's job is to determine rate-sensitive and decay/runoff rates through:

- Intuition and seat-of-the pants
- Industry and government standards
- Individual testing at your credit union
 - **Use a consultant**
 - **Do it yourself**



SUBSTANCE vs. FORM

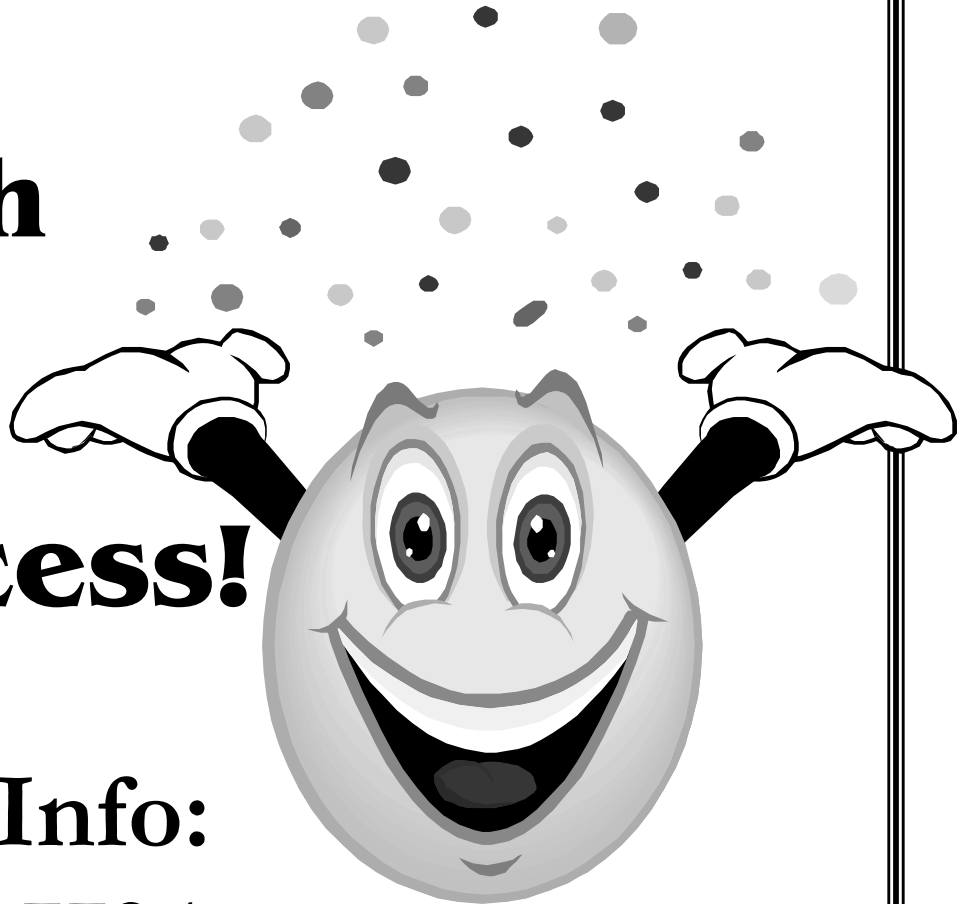
- ❖ For many credit unions, the economic nature of shares provides a source of long-term, nonrate-sensitive funds
- ❖ This is the primary reason why credit unions can maintain a mismatch on the balance sheet and yet, in substance, still have low to moderate interest rate risk
- ❖ This phenomenon is changing:
 - Members are becoming less willing to let the credit union use their money at low rates
 - The percentage of loans and investments funded by nonmaturity shares and deposits is declining
 - Credit unions are becoming more reliant on rate-sensitive deposits
- ❖ Credit union management needs to be very proactive when managing the credit union's balance sheet

SUMMING IT UP

- ❖ Nonmaturity shares and deposits
 - No maturity date
 - No contractual rate
- ❖ Important — Make a large percentage of total shares
- ❖ Substance vs. Form — Substance is what counts most
- ❖ Economic substance of shares depends on their nature.
 - Some may be: — Not rate-sensitive
 - Not short-term
 - Others may: — Exhibit rate-sensitivity
- ❖ Credit union management must evaluate and determine rate sensitivity and decay rates
- ❖ Economic substance of shares may allow a balance sheet mismatch
- ❖ Nature of playing field is changing — Credit union management must be proactive in managing the balance sheet

**We at
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Incorporated**

Wish You Success!



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